Declassified in Part - Sanitized Copy Approved for Release 2012/01/18 : CIA-RDP85T00875R00160002

Declassified in Part - Sanitized Copy Approved for Release 2012/01/18 : CIA-RDP85T00875R00160002

25X1

~~Secret~~

Doc/Ser

DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Taiwan's Capability to Finance Additional Military Outlays

~~Secret~~

ER IM 69-114
August 1969

Copy No. 48

DSB FILE COPY
RETURN TO 1E-61

WARNING

This document contains information affecting the national defense of the United States, within the meaning of Title 18, sections 793 and 794, of the US Code, as amended. Its transmission or revelation of its contents to or receipt by an unauthorized person is prohibited by law.

Declassified in Part - Sanitized Copy Approved for Release 2012/01/18 : CIA-RDP85T00875R001600020116-1

25X1

CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1969

INTELLIGENCE MEMORANDUM

Taiwan's Capability to Finance Additional Military Outlays

Introduction

The US military grant aid program which has supplied almost all of Taiwan's weapons, spare parts, and other supplies is being phased out. Military aid deliveries, which totaled $3.2 billion from 1949 through 30 June 1969 and averaged about $95 million annually in the five years ending 1968,* will average only about $45 million annually during the next five years. Despite this cut in aid, Taiwan wants to modernize its armed forces and, because it has almost no capability to produce the more complex military hardware, will have to purchase these items abroad.

According to joint estimates by the Defense and State Departments, Taipei will spend $238 million in foreign exchange on its military establishment during the five-year period 1969-73. Of this amount, $213 million will be necessary to maintain the present flow of equipment and in this way offset the decline in US grant military aid. The remaining $25 million is a partial repayment, made during 1969-73, of a $100 million loan now being negotiated which will be used to purchase the equipment needed

* *Changed from fiscal year (1 July-30 June) basis to a calendar year basis to fit in with other data.*

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence and the Office of National Estimates.

25X1

to modernize Taiwan's armed forces.* This memorandum estimates Taipei's ability to earn the necessary foreign exchange under various growth assumptions.**

** The $25 million represents principal and interest payments during the five-year period on commercial loans contracted to finance equipment purchases of $20 million annually for a total of $100 million.*

*** For a detailed discussion of the methodology used to make these estimates, see the Appendixes.*

Military Spending and Economic Growth

1. Nationalist China has maintained an exceptionally large military establishment since it left the Mainland in 1949. Its forces, numbering about 600,000, constitute a very high, although declining, share of the population (4.5 percent in 1969). Military expenditures have consistently accounted for about 85 percent of central government outlays and about half of all government spending. Self-financed military expenditures -- excluding foreign aid -- are equivalent to about 9.4 percent of gross national product (GNP) in 1969.

2. Thus far, military spending has not hindered economic growth. During the 1950s the economy was supported by massive amounts of US economic and military aid, and even though US economic aid was phased out in the 1960s, the economy still expanded at impressive rates. The growth of output, exports, investments, and savings has been so rapid that reductions in economic assistance have had only marginal effects. Some 30 percent of the annual increase in GNP has been saved. Moreover, some military expenditures had positive indirect effects on economic growth. The army taught young men from rural areas discipline and skills and provided employment for Mainland Chinese who otherwise would have been difficult to integrate into the civilian economy. Without the military services there probably would have been a larger amount of unemployment or underemployment.

3. Taiwan is one of the few less developed countries to have achieved an average annual growth rate of nearly 10 percent for a decade. By 1968, GNP reached $4.2 billion -- about $300 per capita -- and the overall per capita level and the broad structure of output in Taiwan was similar to that of Japan in the mid-1950s.

4. The mainspring of growth has been the vigorous rise in exports at an average annual rate of 22 percent since 1960. This extraordinary performance was made possible by a rapid diversification of exports. For example, sugar accounted for more than half of all exports in 1958 but for less than 6 percent in 1968. Besides penetrating specialized agricultural markets with such high-value products as mushrooms, asparagus, and pineapples, Taiwan has

spectacularly increased exports of manufactured goods by more than 34 percent annually since 1960; by 1968, manufactures accounted for 53 percent of total exports. Textiles have been the leader, but there also has been a sharp rise in exports of products such as electronic equipment, plastic articles, plywood, and chemicals.

5. Exported manufactures have been produced primarily in new plants built with US, Japanese, and overseas Chinese capital and have been sold mainly in the US market. Capital has been attracted to the island by an abundant, hard-working, and relatively easily trained but low-wage labor force and by a stable government offering excellent tax and other benefits to new export industries.

6. Thanks to an export-oriented growth pattern, Taiwan has avoided the balance-of-payments problems characteristic of so many less developed countries. In most developing countries, industry is oriented to import substitution and produces almost solely for the domestic market under heavy protection from foreign competition. Almost invariably, production costs are too high to permit exports. This form of industrial development often fails to reduce dependence on imports because of the increasing requirements for imported materials and components. Moreover, import substitution becomes more difficult as a country moves from the simple to the more sophisticated industrial products and technologies.

7. In Taiwan net export earnings from new industries have risen at phenomenal rates, while payments for imports of machinery have largely been deferred because these imports were mostly covered by private foreign investments. At the same time, the value of agricultural exports was boosted through diversification and increased local processing. Thus foreign exchange earnings were more than sufficient to pay for imports, even at very high rates of economic growth.

8. During the 1960s, Taiwan was able to finance an annual growth of 15 percent in imports, to increase foreign exchange reserves, and to greatly reduce its reliance on US economic aid. In the early part of the decade, as high as 37 percent of imports were financed either by US grants or highly concessionary loans; by 1968, about 1 percent was so financed. Since 1965 there have been virtually no new US

economic assistance commitments, and most funds previously committed had been utilized by 1968. Because most of the $1.1 billion in US economic aid received since 1949 represented grants or highly concessionary loans, debt repayments have been very low. In 1968, debt servicing amounted to less than 6 percent of total foreign exchange earnings.

Financing Additional Military Spending

9. Now that almost all imports are self-financed or paid for from non-concessionary loans, a continuation of past export and production trends will lead to an accumulation of large foreign exchange surpluses unless new uses are found for this money. If, for example, the rate of growth of exports is the same in the next five years as in the past five years, Taipei will probably accumulate a foreign exchange surplus of about $1.1 billion -- about five times the estimated military outlays of $238 million.* As foreign investment grows, debt repayment also will increase, but the ratio of debt service (investment income payments and debt repayment) to foreign exchange earnings (exports and other current account earnings) by the end of the period would be only about 13 percent. This ratio compares favorably with countries growing much less rapidly and very favorably with those experiencing rates comparable to Taiwan. Japan and Mexico, for example, have debt service ratios of around 50 percent. Despite these high ratios, foreign investors continue to demonstrate confidence in these countries because of the rapid growth of production and exports and because the governments maintain political stability.

10. For the next five years the chances for maintaining export growth rates as high or nearly as high as in the last few years appear very good. In the first half of 1969, exports increased by almost 30 percent over the same period in 1968. Approved foreign investment, which leads to increased exports of manufactures, increased by more than 30 percent in value in 1968 and accounted for about 25 percent

* *The war in Vietnam boosted Taiwan's exports by about $70 million in 1966, but these have since fallen greatly and since 1968 the direct economic effect of the war on Taiwan has been very small.*

25X1

of the value of all such approvals since 1952. Furthermore, the Kaohsiung Export Processing Zone (similar to a free trade zone) has reached nearly half the expected annual export capacity of at least $160 million per year; a second and larger export processing zone will be opened in 1970, and a third zone is in the advanced planning stage. Exports of agricultural products should also do well. The important food canning industry already has plans to diversify its export product line and promote foreign sales through a joint council.

11. Even if the export growth rate declined by as much as a third -- to 15 percent annually -- Taiwan could still easily manage its planned military spending and pay for imports required to sustain a 10 percent growth rate in GNP. This would require about $100 to $200 million in additional foreign borrowing during the five-year period to meet the military outlays, to pay for additional debt servicing, and to maintain reserves at at least 25 percent of imports. The additional borrowing should not prove difficult, however, because of the low debt service burden.

12. Even in the highly unlikely event that the export growth rate was cut in half -- to about 11 percent -- Taiwan would probably have sufficient foreign exchange for the new military purchases as the rest of the economy slowed down. A major slowdown in the export sector would reverberate throughout the economy. Consumer demand would be off, and investment rates would drop very sharply. For example, if the present rate of growth of GNP were to decline from the present 10 percent to 7 percent because of an export slowdown, the required average annual increase in domestic investment over the next five years would be only 5 percent, compared with 15 percent if growth continued at 10 percent. The resulting decline in demand for consumption and investment goods would be reflected in a reduction in the growth of imports. At an 11 percent annual increase in exports, Taiwan could afford the additional military burden and at least an 8 percent annual rise in imports, an amount probably sufficient to maintain a growth rate in GNP of 7 percent.

13. Some Western observers have voiced concern about the impact of additional military outlays on the domestic economy or the government's fiscal position. But almost all the spending will be for

foreign goods, and very little money will enter the local currency stream where it could create inflationary conditions. The tax burden in Taiwan is still relatively low, and raising revenues to cover additional military spending should not be difficult. In addition, the new outlays can be financed domestically through a bookkeeping transaction between the government and the central bank because the government does not need local currency to buy these goods. Moreover, Taipei has shown, and is likely to continue to demonstrate, considerable prudence in both fiscal and monetary matters.

14. There is, of course, a possibility that Taiwan will spend more than $20 million annually on acquiring more modern military hardware in the next five years. A key factor in any decision would be Taipei's evaluation of US intentions to maintain its presence in Asia, especially the pledge to protect Taiwan from Mainland incursions. Also important will be the Chinese Nationalist leaders' assessment of how much emphasis should be placed on their pledge to return to the Mainland as a political tool in maintaining cohesion on Taiwan and its stature abroad. Taiwan's rapid growth over a decade has given its rulers increased self-confidence and has somewhat reduced the friction between the Taiwanese and Nationalist Chinese because both have obtained rapidly improving living standards. In addition, the Mainland pledge has become less important to Taiwan's political stability. Furthermore, there is a growing awareness among Chinese Nationalist leaders that too much military spending could slow the economy.

Conclusions

15. Taiwan is likely to have sufficient foreign exchange to pay for the new outlays required to modernize its armed forces. The most probable case is a continuing expansion of exports at or near the previous rate of 22 percent annually. The basic factors that facilitated the past rapid rise of exports can be expected to remain operative. Foreigners will continue to establish export-oriented firms to take advantage of Taiwan's relatively low-paid, hard-working labor force and the liberal tax benefits offered by a stable government. A considerable number of such investments are now under way, and applications to establish more enterprises continue to be filed with the government.

16. A decline in the export growth rate to 18 percent annually would mark the point at which Taiwan would have to increase foreign borrowing to pay for both the military outlays and an expansion of imports at a rate equal to that of the past eight years. This should not prove difficult, because debt servicing will be low in comparison to foreign exchange earnings. If the export growth rate dropped much below 15 percent, an unlikely event, Taipei could not afford the military outlays unless the expansion of non-export-related imports also slowed. Such a decline would probably occur because the reduction in export growth would reduce the expansion of Taiwan's overall economic growth, which in turn would require less imports.

17. Under any likely circumstances Taipei will probably continue to pursue prudent and pragmatic economic policies which will assist in providing adequate funds to pay for the additional military outlays.

APPENDIX A

Methodology

Two separate procedures were used to determine whether a specified increase in Taipei's military expenditures was consistent with continued rapid economic growth.

25X1

25X1

Page Denied

Next 28 Page(s) In Document Denied